US Watch

WHAT DRIVES US FROM HERE?

Steven Blitz / Andrea Cicione / Christopher Granville

Economics: Housing will not be an answer

- Replacement for faltering exports, flat capex needed for GDP in Q2
- New home sales bounce is a plus, but unlikely to be sustained
- Railcar data underscore weak industry and inventory drawdown

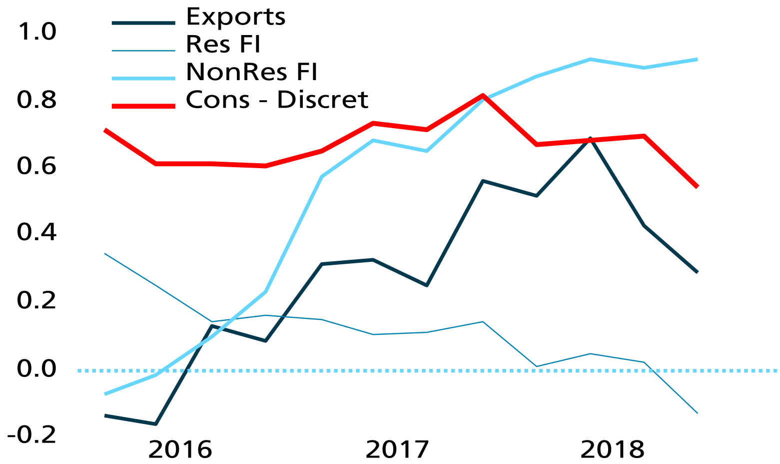
Markets: Inverted curves and US equities

- After a short wobble, stocks have rallied despite the curve inversion
- An inverted curve doesn't necessarily herald an immediate sell-off
- But other warning signs suggest investors should remain cautious

Politics: Trump's Golan gambit

- The investment relevance of Trump's foreign policy is not just China
- The Middle East and oil could yet make an impact via global deflation
- Recognition of the 'Israeli' Golan Heights also highlights wider risks

Shifting Contributions to Real GDP Growth



Source: Thomson Reuters Datastream, TS Lombard

Economics: Housing will not be an answer

- **Replacement for faltering exports, flat capex needed for GDP in Q2**
- **New home sales bounce is a plus, but unlikely to be sustained**
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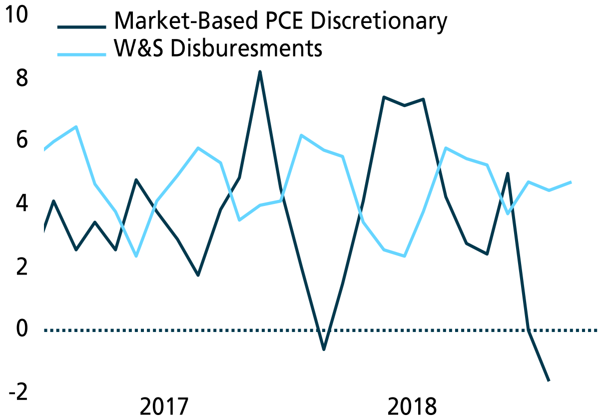
While we wait for real economic activity to be affected by the shift in capital flows from the changes in the yield curve that started late last year, there is still a here-and-now slowdown to deal with. Growth decelerated in Q4 and will slow further in this quarter just ending. The question is what will buoy growth in Q2 beyond an inventory swing and some rebound in consumption. The Fed is hoping the Q1 slowdown is transitory, but even they are not entirely convinced. Recent comments by Janet Yellen and some current FOMC members that neither recession nor Fed rate cuts are on the horizon belie their shaky confidence.

Discretionary PCE* & Wages (3M Ann %Ch)

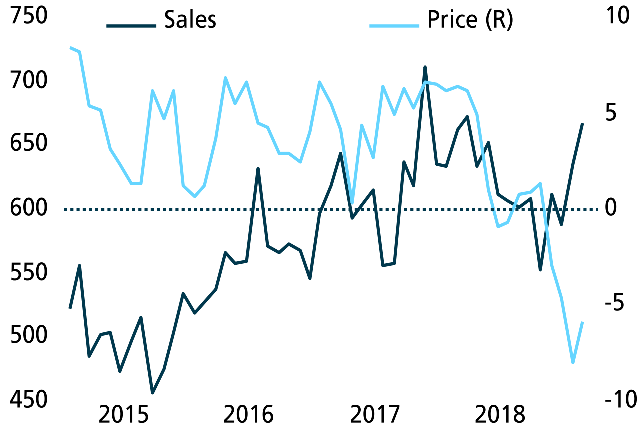
*ex food, energy, hsng, fin svcs, insurance, heatlh



Source: Thomson Reuters Datastream, TS Lombard

Sales of New Single Family Homes vs Prices

000s SAAR; YoY %Ch Median Price New Home Sold (3M MA)



Source: Thomson Reuters Datastream, TS Lombard

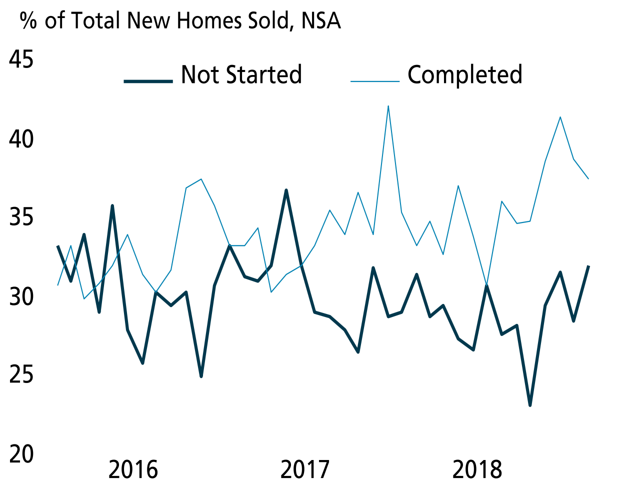
Time was when US economic growth centered on autos and housing. Exports are now an increasingly important contributor to GDP (see front page chart). But the global slowdown has quashed trade growth and a meaningful rebound does not seem likely in the months ahead. Capital goods spending has been an even more important contributor to real GDP, and here too growth has flattened, thanks in large part to Trump's trade tactics disrupting supply chains and raising uncertainties about the location of business investments. Clarity on this score is unlikely to emerge in the near term. The slowdown in profits (in part tied to the drop in global earnings) is also set to hold down growth in capital spending in the coming quarter or two. Capex tends to lag earnings by at least six months if not a year.

The household sector, still buoyed by jobs and income, will contribute to growth, but discretionary spending growth has been on the wane since the middle of last year (see chart above) despite solid, stable growth in wages and salaries (the product of pay and employment growth). The government shutdown played a role in January (we should see a reversal in February retail spending) but so too did the equity market's swoon late last year. That swoon is not likely to be soon forgotten. While the losses have been largely retraced, this is not true for every stock, and people react differently to losses than to gains. It will take time - more than a quick market rebound - to revive confidence to spend, especially given the known headwinds to growth that are in the air. In other words, consumption should trend back towards income, but not run ahead of it.

This brings the focus to the housing market, an underperforming sector relative to GDP throughout this expansion. This was to be expected early in the cycle as mortgage leverage unwound and excess housing supply needed to be absorbed. To date, the best new home sales could muster was a return close to the long-run average of around 600,000. In most cycles, not counting the mortgage-mania years, new home sales would top out at around 800,000. Last year sales slipped as mortgage rates rose, but they have rebounded in the past few months and reached 667,000 in February - a strong number that makes up for below-trend sales several months back. The three-month average is 630,000 and the six-month average is 610,000.

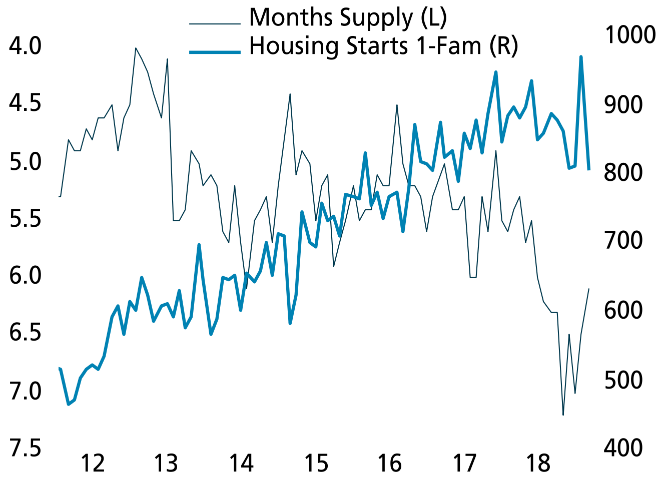
It is unlikely that February's annualised pace of 667,000 will be sustained. For one thing, home builders needed to "purchase" these sales with much lower prices regardless of the fall in mortgage rates (see chart above). When sales were last this high, in late 2017, YoY growth in the median price of new homes sold was nearing 7%; now it is falling at around that rate. It looks to us that homebuilders are essentially clearing out inventory as best they can, as a greater share of homes sold are completed rather than not yet built (see chart below). Indeed, even though the number of months needed to clear the supply of homes has fallen, it is still above the builders' comfort zone – meaning more than the current jump in sales is needed to kick off a renewed surge in housing starts (see chart below).

New Homes Sold by State of Completion



Source: Thomson Reuters Datastream, TS Lombard

More Supply, Less Future Construction

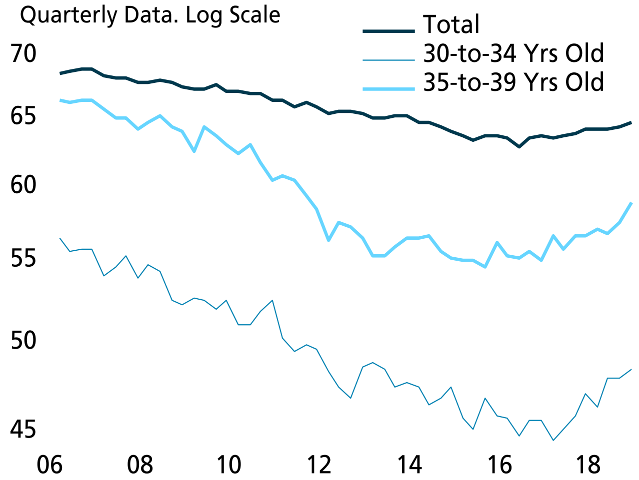


Source: Thomson Reuters Datastream, TS Lombard

Demographics very much favour an upturn in home building, but even here the rebound in homeownership rates has been sluggish for those in their thirties (see chart below). In the US, the average age of the first-time homebuyer is around 33 to 34 years old. The maturing of millennials from renters into owners has long been one of our themes, and it still lends an underlying upward bias to new home buying in the coming years. The degree of that bias is, however, key to understanding whether the current drop in rates will spark a surge in new home sales up towards 800,000. We think not. For one, the expansion of the 25-34 age bracket in the workforce has slowed. The combination of lower real starting incomes compared to their parents' and the overhang of student loans is pushing out the average age of a first-time home buyer is also pushing out the time line of when the first home is purchased.

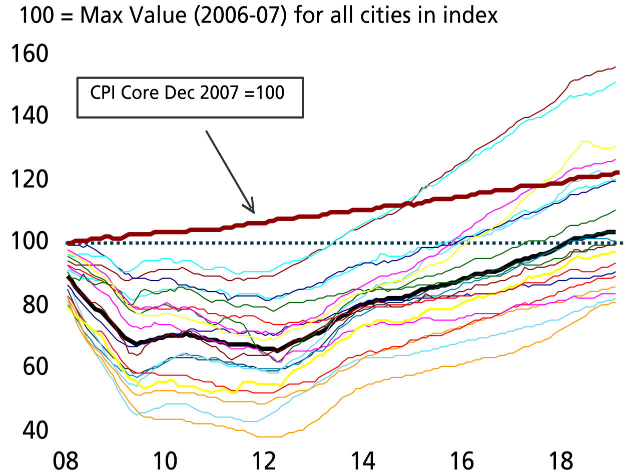
In truth, affordability isn't necessarily the main issue, as homes are more affordable than they were throughout the 1990s and early 2000s – this was true even when last year mortgage rates were peaking. While it is true that mortgages are not as readily available as they were then, we suspect the main reason has to do with low inflation and alternative assets in which to save. When we look at the run of existing home prices according to Case-Shiller, prices in many of the metro-areas in their 20-city index are still below their 2006-07 highs (see chart below). The average price is up about 3.8% from its peak while core CPI is up 22.5% since December 2007. Unless mortgage rates are negative, or your house is in a hot area such as San Francisco, Seattle, Denver or Dallas (or Central Park West in NYC), there are better investments. Further, recent federal tax changes have raised the after-tax cost of carrying a home, especially in high-tax states.

Homeownership Rate for Selected Age Groups



Source: Thomson Reuters Datastream, TS Lombard

Case-Shiller Home Prices 20 City Index (Black)



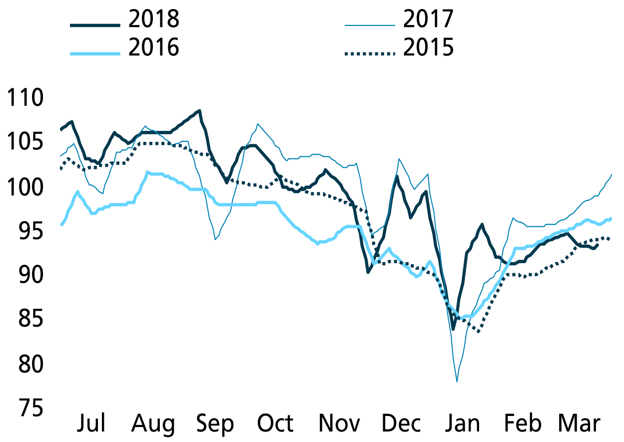
Source: Thomson Reuters Datastream, TS Lombard

There are practical reasons to own a home, but the current generation's parents also bought to own a tax-advantaged leveraged asset presumed to outperform inflation. But inflation is not in the vocabulary of maturing millennials when they consider their drivers of asset accumulation. Even current home owners are less than certain about price. The level of outstanding home equity loans continues to drop even though homeowner equity in residential real estate is finally back to pre-recession levels. As we noted above in relation to equity losses, people remember capital losses much longer than gains, especially after the shock of a sharp loss. What all this points to is a steady new home sales environment, with construction eventually picking up once inventories of completed homes have dropped to an acceptable level. But the conditions for a surge in new home sales seem unlikely to fall into place. The probability of housing once again becoming a large positive contributor to real GDP seems low – it will be a positive force, yes, but probably not powerful enough to fully offset the loss of export growth.

A last word on the economy from the railcar data (charts below). Cyclical cargo reflects a production sector that is still weakening. Containers riding the rails suggest large retailers and wholesalers are not yet ready to restock inventory. The conclusion? No recession but achieving 2%-plus growth will be very hard. Further, when the reversal of capital flows that began late last year begins to negatively impact real activity this summer, the Fed will cut rates.

Railcar Loadings Cyclical Cargo (000s)

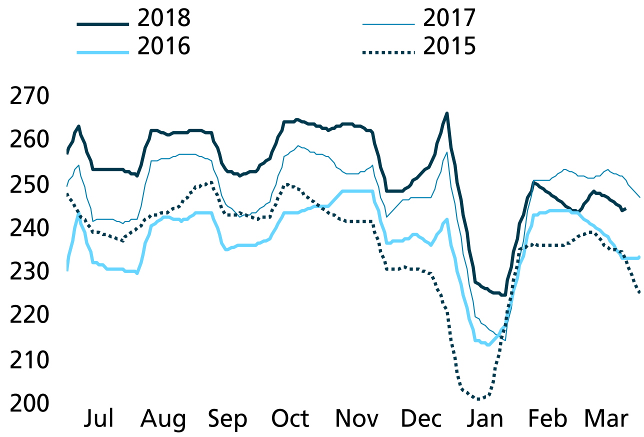
Chemicals, Metal, Nonmetallic & Forest Prod -- 4Wk Mov Avg



Source: Thomson Reuters Datastream, TS Lombard

Railcar Loadings of Containers

(4W Mov Avg, 000s of Carloads)



Source: Thomson Reuters Datastream, TS Lombard

Markets: What does an inverted yield curve mean for US equities?

- **After a short wobble, stocks have rallied despite the curve inversion**
- **An inverted curve doesn't necessarily herald an immediate sell-off**
- **But other warning signs suggest investors should remain cautious**

The curve has inverted. The 3m10y section of the US yield curve, which according to the San Francisco Fed statistically dominates the 2y10y as a recession indicator, inverted on March 22 before turning back positive exactly one week later. The NY Fed's favourite recession signal, the 3m-18m/3m near-term forward spread, has been negative for some time and remains so.

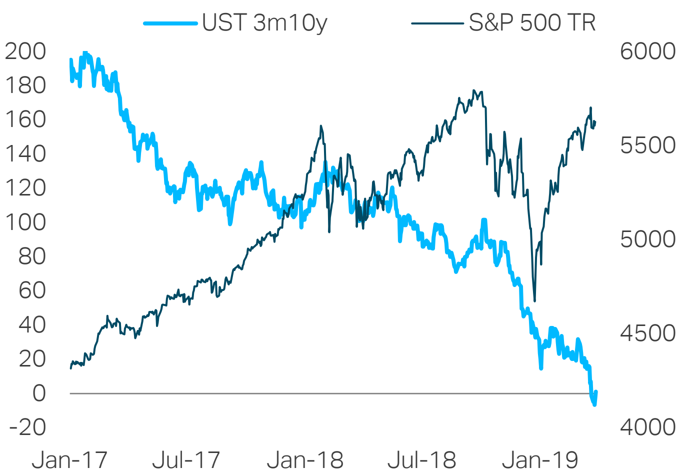
3m-10y inversion always precedes a recession. As Oliver Brennan pointed out in Macro Strategy, a US yield curve inversion is never non-important, as each US recession has been preceded by one. (The track record of the yield curve as a recession indicator outside the US is more mixed.) To be sure, there have been false positives, but these have been exceedingly rare – most notably in 1998. So it's important for investors to pay attention to the curve.

But equities are still on their way to a full recovery. After an initial wobble, stocks (in the US and elsewhere) have quickly stabilised and started to recover. The VIX, which spiked to nearly 18 on Monday, has fallen back below 14. As we've pointed out repeatedly, a VIX below 15 is a strong indication that equites remain on a path of full recovery and are likely to make new highs.

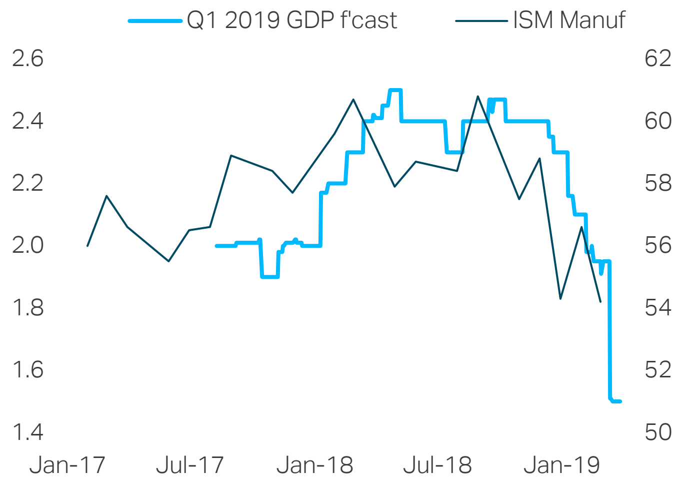
How much does an inversion matter to investors? While the inversion is a reliable macro indicator, the lag between the initial signal and an actual recession tends to be long and variable. In the last such episode, the yield curve flipped sign in February 2006 but a recession started only 22 months later. This long lag means that the validity of the signal for investors is not as good as it is for macroeconomists.

More noise than signal. In the last six inversions, the subsequent six-month returns for the S&P 500 have been virtually zero on average. Arguably this is still a negative outcome, as the mean six-month return for the S&P over the same period has been +4%. But given that the outcomes have fallen in a wide 15% range, as far as stocks go noise clearly dominates signal.

Curve flattening has been good for equities so far…

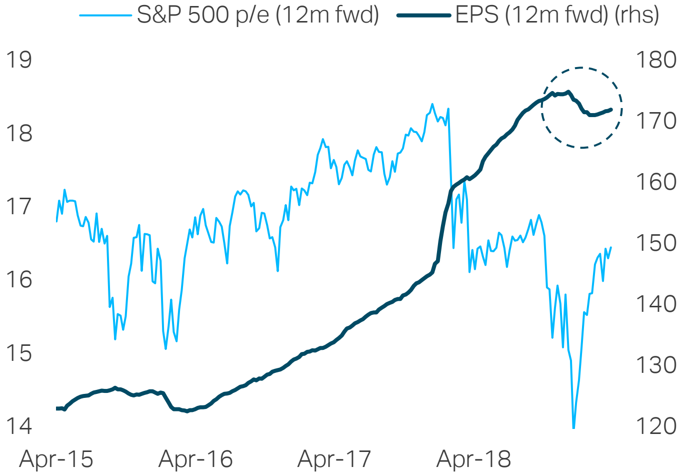


…Even if it reflects a slowing economy



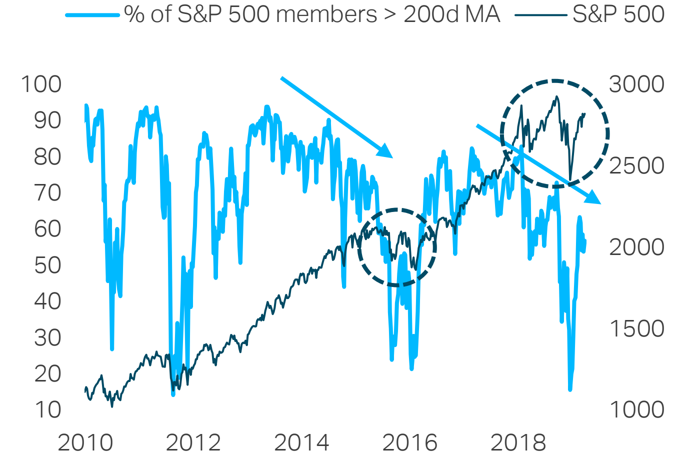
Source: Bloomberg, TS Lombard

EPS forecasts back to climbing after brief pause



Source: Bloomberg, TS Lombard

Narrower market breadth is a warning sign



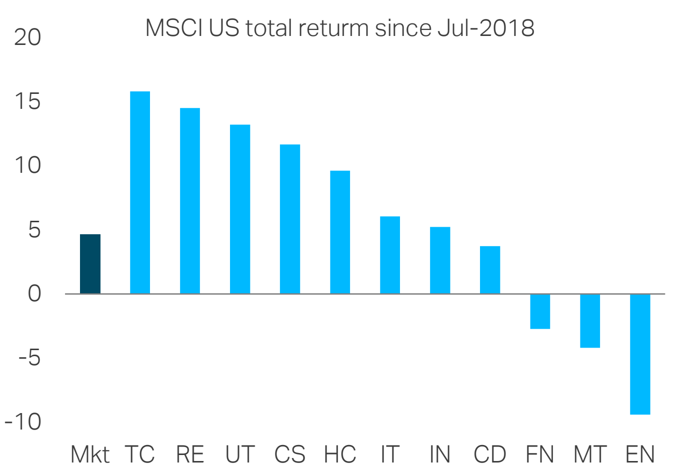
Source: Bloomberg, TS Lombard

But no reason to be bullish. Even though the curve inversion in itself is not a reason to short stocks, we continue to see the risk as balanced from here – hence our neutral recommendation on US equities in Asset Allocation. While markets have welcomed the FOMC's dovish turn, a rate cut by year-end is now virtually priced in. The Fed could soften its stance even further, but this would require continued deterioration in the data, which in turn would spook the market.

Market breadth failing to recover despite a rising market. While a well-behaved VIX is a comforting signal, other indicators are less reassuring. Market breadth (percentage of stocks above their 200d moving average) has continued to deteriorate. In the past this has heralded a very sharp correction, including in mid-2015 and December 2018. Also, the latest recovery has hinged on the strong performance of defensive sectors. The FAANGs have lagged and are further away from making new highs than the market as a whole.

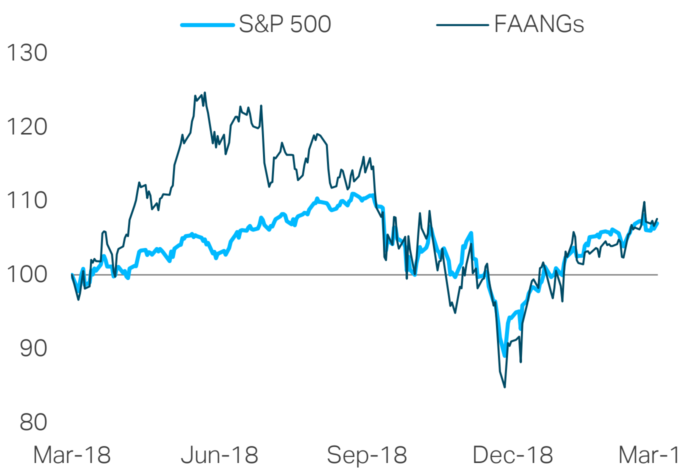
Uptrend losing consistency. Our leading indicators suggest that the US slowdown has legs, making a bullish view on US equities questionable. While a top may not be behind us, the uptrend has become increasingly inconsistent, with repeated market shocks. Investors should trade carefully.

Mostly defensive sectors outperforming



Source: MSCI, Bloomberg, TS Lombard

FAANGs no longer leading the rally in stocks



Source: Bloomberg, TS Lombard

Politics: Trump's Golan gambit

- **Post-China trade war, look to the Middle East for political shocks**
- **The oil price transmission now works indirectly through the global deflationary effect of conflict-driven supply disruption**
- **The potential conflict prompt is the US recognition of the 'Israeli' Golan Heights – a move that also reflects wider geopolitical risks**

The economic fall-out from the US-China trade war may not be the last foreign policy-driven risk to come out of the present political cycle. The question of what other foreign policy initiatives by Donald Trump might disturb the economy points to familiar territory. Because of its importance for global oil supply and prices, the Middle East remains a prime candidate; and last week Trump again stirred the pot in this volatile region by recognizing the Golan Heights, seized by Israel from Syria in the 1967 Six-Day War, as sovereign Israeli territory.

The transmission mechanism from Middle Eastern conflict to investment risks via the oil price has paradoxically survived the shale-driven transformation of global oil supply. A standard view of American Middle East policy up to and including the invasion of Iraq in 2003 was that "it's all about oil". In other words, the US interest in protecting Israel went hand in hand with ensuring reliable oil supply from Saudi Arabia and other regional producers.

Now that the shale revolution has progressed to the brink of making the US a net oil exporter, America's direct economic stake in the Middle East has dwindled. But that has not made the US indifferent to the region. In an interview with the *Financial Times* last week, Deputy Energy Secretary Dan Brouillette said that the shale boom affords the president a "stunning" freedom to "make foreign policy decisions that were simply not available to previous presidents". De-coded, this means that US policy in the Middle East may now concentrate on supporting Israeli interests unconcerned by trade-offs with Arab opinion. The US has nothing to fear now from a hypothetical re-run of the Arab oil embargo after the 1973 Yom Kippur war.

Whether the administration likes it or not, indirect trade-offs with sharp economic implications have not disappeared. Tweeting about his Golan decision, Trump declared Israeli sovereignty over the Heights to be of "critical strategic and security importance to the State of Israel and regional stability." It is at least arguable, however, that his decision will make the Middle East even more unstable than it already is. If Trump's policies ended up fomenting another serious regional conflict, the resulting oil price surge would no longer jeopardise US energy security; but it could well intensify the resurgence of global deflation risks against the background (recalled in the Economics section on page 2 above) of the increasing export dependency of US growth.

Middle East conflict risk now hinges on Iran. US policy is focused on bringing about regime change in Iran for the sake of Israeli security. The US is pursuing this goal by indirect means, as opposed to a repeat of the Iraq invasion. The same rationale helps underpin Trump's pro-Saudi line: while no longer important to the US as an oil supplier, Saudi Arabia is a regional bulwark against Iran. However, now that Trump has recognized Israel's annexation of Arab lands (the Golan), the Saudi leadership must weigh the risks for its prestige both at home and among wider Arab opinion of allowing Iran to be perceived as the sole regional champion of the "anti-Zionist" cause. Despite Saudi Arabia's military campaign in Yemen since 2015 being in part a proxy war against Iran (though in reality that would be a great over-simplification of the Yemen conflict), US mainstream Congressional opinion was already turning against Saudi Arabia even before the outrage of the Khashoggi murder last October.

It follows that Israel, rather than Saudi Arabia, is the most likely originator of US-supported military escalation against Iran. The timing of Trump's recognition of the Golan Heights as Israeli territory is clearly designed to help Israeli Prime Minister Benjamin Netanhayu hold onto power in next week's Israeli election. A re-elected Netanhayu may be expected to continue acting on the basis that – as he put it when welcoming Trump's Golan decision – "Iran seeks to use Syria as a platform to destroy Israel". That implies continued, if not intensified, air strikes on the military assets in Syria of Iran and its Lebanese Hezbollah allies. Syria's ability to retaliate has been strengthened now that it has taken delivery of more advanced air defence systems from Russia – whose military presence in the theatre heightens strategic risks (even though Netanhayu has taken care to maintain active channels of communication with Moscow). It is not hard to imagine escalating conflict in Syria between Israel and Iran (or its proxies) spreading to Lebanon. Regardless of the extent of that escalation, Trump could then weigh in by tightening the US embargo on Iranian oil exports.

Another strand of commentary on Trump's Golan decision emphasizes the wider risks to international stability – i.e. going beyond the Middle East – from this infringement of the "rules-based order". The rule in question is the "Westphalian" one of the inviolability of the recognized frontiers of sovereign states. As it happens, Trump's Golan gambit fell on the twentieth anniversary of the start of NATO's air campaign against Yugoslavia. Many liberal critics of the Bush-Cheney administration on this score seem to forget that it was Bill Clinton who first crossed the Westphalian Rubicon by attacking a sovereign state and detaching part of its recognized territory (Kosovo).

These debates boil down to case-by-case arguments. The dismemberment of Yugoslavia was justified on the basis of the "responsibility to protect" Albanian Kosovars from the threat of ethnic cleansing. Returning to the present, US officials answer the question actively aired in last week's op-ed columns about the difference between the Golan and Crimea by claiming that Israel must defend itself against external aggressors whereas Russia is an aggressor. Whatever the merits of such debating points, their proponents are both judge and jury. In other words, behind the veneer of rules lurks the age-old reality of 'might is right'. Developments like Trump's decision on the Golan Heights, as with Russian and Chinese territorial aggrandisement, provide repeated reminders that the real international order is now one of global big-power competition – perhaps more reminiscent of the nineteenth century than the Cold War. While remote from economic drivers, let alone real-time investment risks, this reality of a costly struggle for mastery nevertheless deserves a place on asset allocators' radar screens.

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